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**The usual effect of the attempts of governments to encourage consumption, is merely to prevent saving; that is to promote unproductive consumption at the expense of reproductive, and diminish the national wealth by the very means which were intended to increase it. What a country wants to make it richer, is never consumption, but production. Where there is the latter, we may be sure that there is no want of the former.**

**John Stuart Mill, *Essays on Some Unsettled Questions of Political Economy*, 1830**

## WEAKER AND WEAKER

What do the world's leading economists and policymakers know about the chief causes behind the U.S.-led global economic downturn? Read the first sentence in the Organization for Economic Cooperation and Development's *Economic Outlook*, published less than a year ago in December 2000: *"Global economic growth appears to have peaked during the first half of 2000, but world economic prospects remain relatively bright…"* Attached to this rosy assessment was an equally rosy forecast for U.S. economic growth of 3.5% in 2001 and 3.3% in 2002.

Then read what this same top economic organization in the world wrote in its June 2001 *Economic Outlook,* barely four to five months ago: *"Economic growth in the OECD area has been weakening since autumn of 2000, but the forces damping growth are projected to dissipate during the current half-year."* U.S. real GDP growth was projected to accelerate from 1.2% in the first half of 2001 to 1.9% in the second half and further to 3.1% in 2002 and 3.5% in 2003.

The very latest estimate for U.S. economic growth, drawn up at a recent committee meeting of OECD staff economists and government officials and to be published in December, is for 1.1% in 2001 and 1.3% in 2002. Although sharply down, it is already a joke before it is published because to realize this growth rate would require the economy to have already been accelerating. Just the opposite is true. The U.S. recession was under way well before Sept. 11.

Back to our introductory question: What do the world's leading economists and policymakers know about the causes behind this U.S.-led global economic downturn? What does Fed Chairman Alan Greenspan know? Reading many reports from very different sources, we long ago realized that the great majority of economists even in highly responsible positions are at a complete loss to understand what is going on. There is a sea of statistics going into every little detail, but there is very little or no effort to sort out the decisive causal processes that are driving the economies relentlessly downward. The favorite general source of information and assessment are consumer and business surveys. But what else can the consumer say than what he hears and reads? In our view, the policymakers and the responsible economists ought to know better than the man on the street.

In the course of this year the U.S. economy has developed far worse than had generally been expected, and nine rate cuts by the Fed have completely failed to show any desired effect. Yet the faith that almighty Mr. Greenspan and the Federal Reserve can and will successfully reignite economic growth is unshaken. In September, America's industrial production experienced its 12th month of decline, the longest unbroken fall since 1945. Profits are sliding as never before in the whole postwar period, yet the consensus continues to reckon that America's recession will be brief and mild. That is: there will be further economic weakness for the rest of 2001 and early 2002, but it will be followed by a strong recovery in the second half of next year.

Underlying these forecasts is a deeply embedded conviction that the U.S. economy, at bottom, is bursting of economic strength and dynamism. The idea that America might follow Japan with a prolonged period of economic stagnation is emphatically discarded with the argument that the U.S. economy is in a much healthier state than Japan was at the start of the 1990s.

Assessing the U.S. economic downturn, we focus on the miserable profit performance as its chief driving force. There is a widespread view that capital spending has already been slashed and that future cuts will therefore be modest. But perceiving the primary reason for the capital spending crisis not just in existing overcapacity but also in the worst profit crisis since the 1930s, we expect growing downward pressure. According to Dresdner Kleinwort Wasserstein, the reported profits of companies in the S&P 500 index fell by 60% in the year to the second quarter. It's already the biggest decline since the Depression. As a result, profits in the non-financial corporate sector fell to 8.1% of GDP in the second quarter, down from 12.5% in 1997. Profits have slumped further since then.

In our view, a little knowledge in economic theory is helpful in recognizing the crucial importance of profits in the capitalist economy.

## SHORT OF THEORY

In 1925, in an article about U.S. monetary policy after the 1920 recession, Professor Friedrich A. Hayek said about the analytical work of American economists that *"they do not begin from a definite, basic theoretical perception of the economic process, but content themselves with gaining as detailed as possible a picture of the typical course of a cycle with a detailed statistical investigation of the behavior of the individual factors in each phase of the cycle. It is their hope that, from the insights they thereby gain into the relative behavior of the individual branches of production, etc., they will then be able to derive explanations as to the nature of the interrelationships between them."*

In a footnote, Hayek added, *"this approach is an outflow from a general trend in more recent American economics. Under the influence of the objective (behavioristic) psychology which has come to the forefront there in recent years, American economics had turned to an ever increasing extent away from purely theoretical research aimed at an understanding of economic activity. Drawing extensively upon statistical series, it now seeks primarily to construct a picture of the path typically followed by all economic processes."*

Under the leadership of W.C. Mitchell, American economists since the 1920s have been devoting their energies to extensive statistical research, believing that only accurate statistical techniques could capture the business cycle in all its complexities. With it disappeared any interest in economic theory. It was discarded as being responsible for totally inadequate monocausal explanations of the business cycle. Professor Bullock, the Principal of the Harvard Economic Society, constantly emphasized the complete absence of theoretical prepossession with which the work of the Institute was carried out.

In this respect, European economists used to hold a diametrically opposite view. In their opinion, the practical value of statistical research and related attempts of business forecasting depend in the first place upon the correctness of the underlying theoretical conception, giving guidance both in selecting the phenomena to be investigated and in enabling the observer to distinguish between causes and effects. Putting it differently: European economists primarily wanted to understand the economic processes, while American economists have always wanted maximum information, caring very little or not at all for underlying theoretical concepts.

This diametric difference in approach between American and European economists has been accompanied by a flagrant divergence in the perception of what essentially generates economic growth and prosperity. Ever since Adam Smith published his *Inquiry into the Nature and Causes of the Wealth of Nation* more than 200 years ago, it was undisputed doctrine that there is but one single route towards economic growth and the creation of wealth—through saving and capital accumulation in tangible, income-yielding assets.

Observing more or less regular fluctuations in economic activity, European economists—in particular Austrians, Swedes and Germans—in the early 1900s began moreover to develop theories that tried to explain the nature and causes of these fluctuations. In particular under the influence of a Russian economist, Tugan-Baranowski (1901), it became commonplace opinion to regard capital investment as the key variable and prime mover in the process of economic growth and its cyclical fluctuations, with consumption but passively responding in their wake.

***In this model, rising capital investment is the one and only component in the economy that pulls up with it everything else that matters in the process of creating growth and prosperity: capacity, production, productivity, output and consumer incomes.***

These economists had no regard at all for consumption. For a consumer to spend money, he has to earn it first. As consumer credit was not yet invented and practiced, the consumer's purchasing power could only come from current production. As somebody once said, only in the alphabet does consumption precede production. What mattered for economic growth and the creation of wealth was assuring enough capital investment spurred by promising profit prospects. As a result, the attention of all economists focused on two aggregates: adequate profits and adequate capital investment. Where there is enough of the two, all problems of production, incomes, productivity, wealth creation and consumption take care of themselves.

## CONSUMPTION VS. INVESTMENT

This consensus about the singular importance of capital investment and profits in generating economic growth and prosperity effectively cracked in the 1920s, and the country where it cracked was the United States. While American producers—Henry Ford in the first place—discovered consumer credit as a new, revolutionary device to boost sales of their products, American economists became obsessed with the idea that a high level of consumer spending is necessary to keep businesses investing and the economy growing.

In line with this perception, the policies of all presidents, literally from Herbert Hoover to George W. Bush, have been overwhelmingly aimed at priming the consumer's pump with cuts in personal taxes while providing little or no aid for business investment. Even when double-digit inflation reared its head in 1974, the recommended policy was not to stimulate investment, but rather to increase consumption through the purest demand side tax cut of all, a rebate. Nor did the big tax cuts under President Ronald Reagan in 1981 make the slightest difference in this respect. They were of exactly the same pattern. New and different was only their justification as work incentives that strengthen the economy's supply side. As usual, they effectively fueled a boom in consumer spending, while business investment went sharply downhill.

It is generally assumed that this notorious American love affair with consumption is the work of John Maynard Keynes. That is mistaken. First of all, it goes back to the 1920s, long before Keynes began to preach his new demand-side economics; and second, he did not at all share this love for consumption. He shared the prevailing European view that economic growth is governed by capital spending and its fluctuations, with consumer incomes following passively in its wake. But looking at economies with large unemployed resources, he focused exclusively on the demand effects of capital spending, while emphasizing its magnified effects on consumer incomes via the so-called "multiplier effects."

For the same reason, by the way, he had no interest in productivity growth. To Keynes, the prime cause of the Depression was declining investment rather than under-consumption. In the *Treatise of Money* he says explicitly, *"The boom of 1928-29 and the slump of 1929-30 in the United States correspond respectively to an excess and deficiency of investment."*

In his General Theory, he explicitly verbalized his utter skepticism about *"the important schools of thought which maintain that the chronic tendency of contemporary societies of under-employment is to be traced to under-consumption… If it is impracticable materially to increase investment, obviously there is no means of*

*securing a higher level of employment except by increasing consumption... But even if we were to decide that it would be better to increase capital more slowly and to concentrate effort on increasing consumption, we must decide this with open eyes after well considering the alternative.* ***I am myself impressed by the great social advantages of increasing the stock of capital until it ceases to be scarce."***

## AN ECONOMY GEARED TOWARD CONSUMPTION

In his book *Capital in the American Economy* (1961), Professor Simon Kuznets writes: *"This country's economy is geared to rising consumption, and our institutions and patterns of social behavior encourage higher consumption per capita… Unless in the next few years the private sector can generate savings and capital formation in a greater proportion to a rising product, the pressure in the demand for goods upon the supply of savings will persist."*

Translated into colloquial language, the latter sentence says: If we fail to increase our ratios of saving and capital investment, our living standard is bound to fall. During the 1950s gross saving accounted for about 20% and net capital investment for about 5-6% of gross national product. This compared with pre-war net investment ratios between 10-12% of gross national product. For Mr. Kuznets this was a most disturbing development because only net capital investment adds to the economy's capital stock. So he wonders in his book *"why the ultimate consumers in our rapidly growing economy manage to save only a small proportion of their income (at best slightly over 10%), and a proportion which, on a net basis, declined rather than rose, despite rising real income per capita."*

Mr. Kuznets would be turning in his grave if he learned where these ratios are today: personal saving close to zero of disposable income and net fixed capital formation around 1% of gross domestic product in the last few years. Among industrial countries, these are unprecedented records, though of utterly negative character.

This brings us to the present. Tracking the public discussion about the U.S. economy's sudden sharp downturn, we note in the first place a striking difference between the general eagerness to oblige investors and everybody else with optimistic growth and profits forecasts on the one hand and the total absence of any efforts to explore in some detail the specific macro- and microeconomic forces that are driving this downturn on the other.

## DROWNING IN CREDIT

It is the general apodictic assumption that this downturn's cause or causes must be the same as for all previous post-war economic downturns: tight money and credit. From this follows the further comforting, apodictic assumption that interest rate reductions are the infallible remedy.

Here begins our vehement disagreement. The Fed actually raised its federal funds rate by 175 basis points, from 4.75% to 6.5%, between June 1999 and May 2000. But 50 basis points of this total undid the rate cuts in October-November 1998 on the occasion of the Long Term Capital Management hedge fund crisis.

In any case, it is blatantly obvious that credit creation in the United States went completely berserk in 1998. Total non-federal borrowing jumped from $781.3 billion in 1997 to $1,076.2 billion in 1998, and financial credit took off from $653.8 billion to $1,073.8 billion. In combination, the two credit flows skyrocketed from one year to the next by 50%, and in just that year Mr. Greenspan lowered the Fed's rate. What's more, he waited with the first rate hike until June 1999.

The important thing to see now is that this credit deluge, once unleashed, has continued unabated ever since. Consumer borrowing in the second quarter of 2001 hit a new record-high of $660 billion, annual rate. Corporations have slowed their borrowing, but compared to past recessions it has remained sky-high. In the second quarter of 2001, it was running at an annual rate of $480 billion, as compared with a net repayment of business credit during the three years 1991-93. Non-federal borrowing has risen $622 billion from end-2000 to

August 2001. During the year before, the rise was $686 billion.

*The Wall Street Journal* reported (Thomson Financial Service data) that third-quarter U.S. stock and bond issuance jumped 21% to $609 billion, *"the fourth busiest quarter ever..."* Year-to-date, total U.S. debt and equity issuance surpassed $2 trillion, up 31% from last year. According to the same report, U.S. long-term debt issuance surged 60% to $930.5 billion, while convertible bond issuance was up 97% to $70.1 billion.

***Far from starving of credit, the U.S. economy is drowning in credit. For us, there is simply no way to make sensible and reasonable use of such a credit deluge. In short, the general attempt to explain the U.S. economy's drastic weakening with credit tightness is just absurd. Rather the obvious question to be asked and examined is why the runaway credit expansion is failing to have any positive effects on the economy and the financial markets.***

## THE KEY ISSUE: PROFITS

Definitely it is not tight money and credit that is driving the economy into recession, but what else could it be? We offer a simple and plausible explanation: it is the U.S. economy's worst profits carnage in the whole postwar period. For years, Wall Street has lured investors with the story of a technology-led productivity and profits miracle that fully justified the skyward climb of stock prices. We have just as stubbornly insisted that, first of all, the new technology is totally lacking the features that could make for high profitability; and second, that the general profit hype had no resemblance with the poor actual numbers.

In hindsight, it is manifest that Wall Street analysts created absurdly over-blown profit expectations about the production and the use of the new information high-tech. The result was the two correlated super-sized bubbles that we have observed, the one in stock prices and the other one in high-tech capital spending. The question is what has actually pricked these two bubbles. The consensus regards the Fed's rate hikes as the main cause. In our view, the true cause was businesses' and investors' general awakening to the poor reality of business profits. As a result, the former have slashed their capital investment and the latter, their stock purchases.

It has taken investors, economists and analysts a long time to take any notice of America's profit misery. After all, fears of dismal corporate profit reports and warnings are haunting the stock market and hitting individual stock prices. Yet when it comes to the macroeconomic discussion about the U.S. economy as a whole and its prospects, the disastrous profit performance and its fatal consequences for capital spending still enjoy gross neglect. Instead, the limelight is on consumer confidence and consumer spending, being widely regarded as the economy's most important demand component. For the great majority of American economists, the number one issue for the economic outlook is what the consumer does. There is a widespread notion in America that consumer demand, not business investment, drives economic growth.

## POLICY FIASCO

When the Fed began to cut its interest rate early this year, there was instant agreement that this would jump-start the economy by the middle of the year. Nine rate cuts in nine months are behind us. It was easily the most aggressive monetary easing in history. In addition, billions on billions of dollars were added to consumer purchasing power through the tax refunds and mortgage refinancing. And what is the impact on the economy and the financial markets?

In short, not only has all this failed to start a recovery, it has, worse still, even failed to halt the economy's further decline. It is even accelerating. For the bullish consensus, however, it is reason for self-congratulation because still worse was prevented. On our part, we wonder about the health or sickness of an economy that is standing still with such rampant money and credit creation.

For us, this is definitely not a policy success but an outright policy fiasco. According to Thomson Financial/First Call, more than 400 companies of the S&P 500 had already warned about lower earnings before

Sept. 11. On this basis, analysts were expecting the companies of that index to report profits down nearly 15% in the third quarter. Since the attack, those estimates have been revised sharply downward to a decline of 22%.

Judging by these numbers, the recognition of the profits disaster appears, at long last, to be sinking in. But we doubt it, considering the overwhelming assumption and forecast remains that the U.S. economy's recovery will come early next year—and possibly be V-shaped. We have even read that the terrorist attack has woken policymakers and investors to the fact that the United States was in a recession—and that the emergency measures that it induced in many countries should restore economies and the markets to health more quickly than otherwise would have been the case.

Considering this total fiasco of the most aggressive monetary easing and associated recovery forecasts, one should have expected some rethinking among economists and analysts and a lively discussion about underlying causes of this failure and their possible persistence.

***Definitely, it ought to be clearly recognized by now that this economic slump is of an entirely different nature than any experienced before in the postwar period. Past downturns mainly reflected the rundown of inventories and some fluctuations in building.***

## THE DIFFERENCE

Manifestly, two features distinguish the present U.S. economic downturn from all its predecessors in the whole postwar period: an unprecedented rout of business profits and an unprecedented rout of business capital spending. Clearly the former is the decisive cause, and the latter its effect. At the end of the day, capital spending is determined by profits, to be precise, by profit expectations.

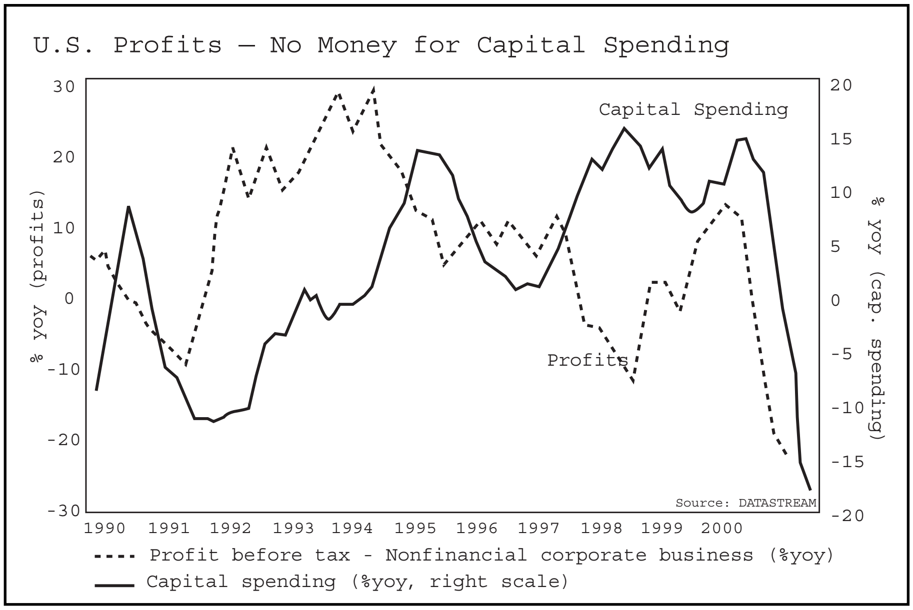
What's more, this profit malaise did not just pop up yesterday. It has been smoldering for years, while the economy was still booming. Before-tax profits of nonfinancial corporations effectively peaked in 1997 with $504.5 billion. Ever since, they are down, first gradually, then steeply. In the second quarter of 2001, they numbered $402.3 billion, at annual rate. While this is already below the level of corporate earnings in 1995, all signs are pointing to worse to come.

To put this profit squeeze into perspective: When Paul Volcker applied his savage rate hikes in the late 1970s, profits of nonfinancial corporations shrank from $160.7 billion in 1978 to $141.5 billion in 1980, coming from $100 billion in 1975. The next and last major profit decline, ushering in recession, was from $235.2 billion in 1988 to $219.3 billion in 1989.

How important is this protracted profit carnage? It's definitely the most important feature of the present U.S. economic downturn because it impacts the economy with tremendous contractive leverage through lower capital spending. Profits govern capital spending, and capital spending governs everything else that matters for economic growth: profits, productivity, consumer incomes, supply and demand. The critical importance of capital spending as the engine of economic growth was the key message of the old economists to which we unreservedly subscribe.

There is an even more important question, and that's about the cause or causes of this extraordinary profit squeeze. Is it just cyclical, reflecting no more than the economy's short-term cyclical fluctuations? Or is it of structural nature, related to longer-term changes in the U.S. economy's structures of demand, output and price-cost pattern?

In our view, the following chart, tracking the rate of profit growth for nonfinancial corporations since 1990, should dispel any doubts about the nature of this dismal profit performance. It definitely qualifies as structural because it has taken place during boom years of record-high economic growth. Not to mention the fact that it makes, of course, a mockery of the hype on Wall Street about a productivity and profit miracle.




## SYSTEMATIC DELUSION

For us, the miserable profit performance during the past few years is *the* most important feature of the U.S. economy's downturn, as we have repeatedly addressed in this letter. The last letter, titled "There was no New Economy," in particular, puts forth a rather comprehensive review of the influences and forces that have fostered the manifest, structural deterioration in U.S. corporate profitability. Overwhelmingly, they are the outgrowth of the specific strategies that Corporate America has pushed to excess in its frantic efforts to please Wall Street and investors with quick, big profit gains creating phantom stock market wealth, but these strategies had foreseeable, negative long-term implications for future economic growth. For us, it was always capitalism après nous le deluge (after us the flood). After all, the inherent malign long-term effects are unfolding with growing force.

***If the objective facts of the American profit malaise are shocking, even more shocking to us, certainly, is the general, cynical and disgraceful response to this development by those concerned. There is not just total denial; there is broad, systematic fraud to conceal the horrible truth and to sustain profit expectations at their absurdly high levels to the best of the stock market.***

This response has two distinctive parts: *first,* there is rigorous disregard of the dismal, official figures and their dismal trend; and *second*, there is a strict, narrow focus on the figures that the individual companies report from *quarter to quarter.* But in order to ensure the necessary, complete obfuscation of the investor, Wall Street and corporate management invented a new measure for reported profits: in short, *expected* profits, instead of actual, past profits. A completely new game in measuring reported corporate earnings developed, facilitating total obfuscation. Its name is to meet estimates of the analysts; estimates, though, that helpful corporations have guided to drastically lower levels for comparison. Again and again, share prices have been sent soaring in this way, although everybody in the market is perfectly aware of this ruse. The one thing that unites them all is their eagerness for higher stock prices.

Recently, *The Wall Street Journal* carried an article titled "Stocks Are More Expensive Than Ever." How could that be, the author asked. Very simple; profits have fallen even faster than stock prices. Though hard to believe, P/E ratios are in general considerably higher than a year ago. For the S&P 500, the average is 29.12 times earnings, up from 27.14 a year ago; for the Dow it is up over the year from 19.82 to lately 23.13. Stocks in the DJ Transport Average are currently trading at almost 400 times earnings, as against 8.95 times a year ago. Aggregate Nasdaq profits are negative. By the way, these numbers compare with a long-term historical average P/E ratio of 14.5.

Even to these miserable numbers there is, however, a big catch. All kinds of tricks have heavily skewed them towards the upside. Reality is much worse. Companies increasingly announce earnings on a "pro forma" or "operating basis" that exclude all major expenses, such as interest costs and depreciation charges. The other day, Vodafone reported an increase in profits by 40% on a "pro forma" basis.

This practice to present these ridiculous "pro forma" figures escalated in 1998 after some companies—among them Yahoo and Amazon—went to new extremes of delusion. Companies concluded that analysts and investors readily swallow anything that makes for bullish appearance and followed suit en masse. Just think of the audacity with which even top blue-chip companies report earnings "up a penny." Again, what unites them all is the eager desire for higher stock prices. Those alone count.

The author of that *Wall Street Journal* article did something utterly unusual. He calculated the earnings of some 250 companies according to *generally accepted accounting principles* in the United States, or GAAP, and found an average P/E ratio of 36.7. This was in August. Considering that stock prices are up since then while corporate earnings are sharply down, we guess that the "honest" P/E ratio must be over 50 by now. For companies in the Nasdaq, total profits are effectively negative. According to calculations by Bloomberg Financial Markets, S&P profits are currently below their level in the recession of 1990.

## PUMP PRIMING

Money supply growth remains on a rampage in the United States. This is now being joined by fiscal stimulus. The federal budget surplus, last projected at $176 billion for fiscal 2002, has every chance to disappear completely, if not to turn into deficit. Congress has already authorized an additional $40 billion of emergency spending for security and to help rebuild New York. On top of that it passed a bailout package for the airline industry that totals $15 billion. Still in planning is the second general stimulus package of about $75 billion, following the tax refund of around $40 billion that was mailed during the past few months. We note further general agreement among policymakers and economists that the stimulation of consumer demand enjoys common support. In the face of heavy under-utilization of capacities, any tax cuts for businesses are discarded as a waste of money.

Will it work? The dollar numbers, for sure, are breathtaking and unprecedented. Yet do not let yourself be fooled by them. Measured against a $10 trillion economy in the grips of recession, the mentioned amounts are a drop in the bucket, accounting for little more than 1% of GDP. In Japan, deficit spending has boosted the government's indebtedness over 10 years from 61% to 138% of GDP. Yet any recoveries quickly aborted again. In spite of a dozen giant stimulus and bailout packages, the recession is deepening. Today, the Japanese economy is sliding into recession with an annual government deficit of around 7% of GDP.

In the 1930s, it was customary to speak of government deficit spending as economic pump priming. This is a process that was common in the days of the well and the cistern. It consisted of pouring water into the top of a dry pump and then working vigorously at the handle until the pump began to operate again in a normal way. It was an artificial expedient put into temporary use, but it succeeded only when the pump itself had been kept in good order. The analogy with fiscal pump priming seems apparent. It will not and cannot succeed in bringing about a lasting business recovery if the economy is not in good working order.

But after many years of experience with deficit spending, quite another question appears far more pertinent: Does it work at all? The new enthusiasm for it in America reminds us a bit ominously of the famous call of an American president some 30 years ago: We are all Keynesians.

It is our principal view that government deficit spending is under any circumstances a useless exercise. A healthy economy will work its way out of recession without it. If it's a sick economy, the deficit will, at best, treat symptoms. More often, it is harmful in the long run. But nothing is more useless than deficit spending that stimulates consumption. The available data clearly indicate that the U.S. economic downturn arises primarily

and overwhelmingly from rapidly shrinking business spending, rather than from inadequate consumer spending.

## CORPORATE FINANCIAL STRESS

To repeat: The prime reason for the American capital-spending crisis is the prolonged profit crisis. The resulting fall in the rate of capacity utilization adds, of course, to the downward pressure. It's already at its lowest in more than 20 years. Clearly, manufacturers have sufficient capacity to meet quite a big rise in consumer demand. Besides, they know perfectly well that there exist numerous underemployed competitors in the rest of the world.

Our earlier question was whether the impending second round of fiscal stimulus will be able to initiate a self-sustaining recovery of the U.S. economy as a whole. For that to happen, it definitely needs strong support from higher capital spending. But given extremely poor profitability and low capacity utilization, that looks most improbable.

There may, actually, be still another obstacle to higher capital spending looming. Corporate America is starting from a financially vulnerable position. It has its roots in the financial markets and in corporate balance sheets. Even companies with household names are going belly up. The reason is that U.S. corporations have piled up debts as never before and that, despite swooning profits, they have been increasing their dividend payments. The result is that capital spending on plants and equipment is exceeding the internally generated cash flow from retained earnings and depreciation charges by an unusually wide margin, the difference being called the "financing gap." Last year, this gap accounted for about one-third of capital spending in the nonfinancial sector.

Until quite recently, any borrowing was rather too easy. Corporate bond financing has been the great hit in the current year, running at an annual rate of more than $400 billion, which exceeded total net corporate borrowing. Yet the writing of brewing difficulties in the market is on the wall. The one sign is rising risk premiums; that is, a rising difference between the yields of corporate bonds and yields on safe Treasuries; and the other one is escalating defaults of the issuers.

Year-to-date, 185 issuers of corporate bonds have defaulted on $76 billion, and about 7% of outstanding issues of junk bonds are in default. Credit-rating agencies, such as Moody's and S&P, continue to see tougher times for many companies. More troubling: during the past quarter 82 U.S. companies with debts of $337 billion have been put on review for a downgrade of their bonds.

There is a convincing view, by the way, that a broad, drastic downgrading of corporate bonds in 1931 and the associated steep fall in their market value were crucial in precipitating the U.S. Depression by fueling two fatal processes. It drastically curtailed new corporate borrowing; and the sharply declining value of bank portfolios caused the banking crisis. In other words, it was the crisis in the corporate bond market that caused the banking crisis, not the other way around. In this light, the implosion of the stock market was not the cause of the Depression; it was the implosion of the corporate debt market. Or, probably, they both did it.

## NOTHING BUT LEVERAGE

By the way, these considerations also highlight the absurdity of the familiar claptrap that central banks can "print money." What they can "print" is only one thing: bank reserves, that is, cash balances in favor of commercial banks. But whether these balances translate into effective credit growth that finances higher spending by the consumer and businesses on goods and services depends entirely on the decisions of borrowers and lenders outside the central bank.

Pondering these questions and looking at the actual, preposterous money and credit figures, we also keep asking ourselves: Who is buying all these bonds and other credit market papers in a country where personal and corporate savings are virtually non-existent compared to these astronomic borrowing figures. It should be clear

who the buyers are: leveraged institutional players who borrow at lower short-term rates in order to finance higher-yielding longer-term paper. With short-term rates around 2.5%, they have a great time again.

Manifest, the most important constituents of this monstrous machinery of financial leveraging are the money market funds and the government-sponsored agencies, like Fannie Mae and Freddie Mac. Enjoying government guarantee, their bonds classify as government securities. Considering that these institutions are frantically increasing their mortgage holdings in vast excess of lending for new building, they are manifestly playing a key role in creating both market liquidity and artificially low mortgage rates.

Year-over-year, Fannie's and Freddie's combined total book of business (retained mortgages and their guaranteed mortgages held in the marketplace) has jumped $417 billion, or 19%, to $2.61 trillion. This compares with $1.1 trillion in 1997. Within three-and-a-half years they have increased their buying and lending by about 150%. In theory, they stabilize the mortgage market; in practice they massively distort the whole bond market, unquestionably with the approval of Mr. Greenspan. The question is what will happen next when the government's surplus vanishes.

## A HORRIBLE PROFIT PATTERN

Pondering the further economic development in the United States, we keep focusing on two aggregates: profits and capital spending. They are the key nerve of a capitalist economy, and it utterly flabbergasts us how little attention the poor profit performance finds in the macroeconomic discussion. Apparently still under the hype of the alleged productivity and profit miracle, few people have realized that the reality in the United States is the worst profit performance during the whole postwar period. Over the three boom years from 1997 to 2000, total domestic profits of U.S. nonfinancial industries declined from $504.3 billion to $491.8 billion. Had it not been for a sharp increase in profits of foreign subsidiaries, it would have been much worse.

In hindsight, profits peaked in the second quarter of 2000, and since then it is downhill with sharply accelerating speed. For manufacturing, it is a virtual profit implosion, and here in particular for producers of durable goods, industrial machinery and equipment, and other electronic equipment. In the latter two groups, aggregate profits have actually plunged into negative territory, while producers of durable goods have suffered a profit slump from $94 billion in 1997 and $63 billion in 2000 to $15.6 billion in the second quarter of 2001.

Not surprisingly, the one major sector in the economy that has enjoyed permanently rising profits right to the most recent past is retail trade. In the second quarter of 2001 it procured overall profits of $85.6 billion, as against $63.9 billion in 1997. For us, frankly speaking, this is a horrible profit structure, reflecting a horrible pattern of economic growth.

To put these numbers into perspective: The last profit decline, ushering in recession, happened in 1989. (The following numbers are at annual rate.) Profits fell from $407 billion in the fourth quarter of 1988 to $356 billion in the third quarter of 1989. When the recession began, profits were rising again. Or take the Volcker profit squeeze of 10 years earlier. Remember, he applied a savage credit squeeze with sky-high interest rates. At the time, overall profits peaked in the third quarter of 1979 at $274.9 billion. They hit their lowest level of $188.2 billion in the fourth quarter of 1982. That constituted a decline of 31%, stretched over three years.

Profits before tax of corporations in the nonfinancial sector in the second quarter of this year were down 22% from their year-earlier level, and after-tax profits 24%. Profit margins plummeted to 4.6% of gross corporate product, approaching the lows in the recession of 1990-91. According to the Levy Institute, S&P 500 after-tax earnings per share recorded their largest year-over-year drop in history, shrinking 67% from their level a year earlier. Operating earnings per share fell 38.9%. This is much worse than the NIPA figures because the companies are undertaking big write-offs on goodwill that were accumulated during the acquisition binge.

Comparing the just described two profit squeezes of the past with what is happening at present, it becomes immediately clear that we are witnessing something that belongs to a completely different category. This is not

a common profit squeeze; it is a profits carnage of extraordinary severity.

## BUT WHY?

Being cognizant of the crucial importance of profits and profit prospects for business capital spending, we note with growing amazement that the whole fraternity of American economists remains in complete denial of this profit horror story. Of course, they dislike it. But it seems to us that they are effectively unaware of it. Being obsessed with consumer confidence, profits barely enter their macroeconomic reflections. Besides, they see their main task in deluding investors with distorted comparisons quarter to quarter.

On our part, we look at profits exclusively from the macroeconomic perspective as prime determinants of business capital spending. Observing an outright disaster, we are pondering two questions: *first,* what are the underlying causes; and *second*, what is the future outlook for profits in consideration of these causes?

Having already explored these questions in earlier letters, we can start our reflections with one short sentence: The U.S. economy's poor profit performance of the past few years has one chief cause; and that is a low and shrinking *net* investment ratio. This has been the U.S. economy's long-term malady for more than three decades, but it has its ups and downs, and lately the malady is dramatically worsening.

Booming business fixed investment has been one of the most prominent features of the U.S. economy in the past few years. But as the composition of investment has been shifting from longer-lived structures and machinery to short-lived assets, such as computers and software, the average rate of depreciation is accelerating. As a consequence, a rising share of capital spending is simply replacing capital stock that wears out. Last year, that share was 64% of total business fixed investment. Gross investment of $118.5 billion, accounting for 30% of GDP growth, compared with net investment of only $52 billion.

But now there is a new catch. Rising depreciation charges have overtaken sharply slower gross investment with the result that ***net*** nonresidential investment has turned negative. The last time that happened was in the Great Depression. That has most unpleasant implications above all for profits. This arises from the fact that, from a macro perspective, increases in aggregate profits have their main source in the expenditures that businesses capitalize. That is their capital spending. The firm that produces and sells the capital goods has a corresponding increase in revenue, but the buying and investing firm has no immediate expense because it capitalizes the expenditures on the purchased assets. Expenses are gradually incurred with the later depreciation charges. Taking the business sector in the aggregate, there has been a corresponding increase in net-worth. As a rule, one can say, where there are big investments there are big profits, and where there are big profits there are big investments. Compared to this key relationship, you can forget about productivity growth.

Bearing this equation in mind, we have always doubted the trumpeted profit miracle in America. It essentially implies that acquisitions, mergers and all those other gimmicks that managers pursue nowadays in their quest for quick profits are futile from the macro perspective. Broadly speaking, the only thing that increases the net-worth and profits of the business sector as a whole is net new investment.

***If you think it over, what has really happened in the frantic pursuit of higher shareholder value? Firms raised their profits simply and quickly by buying the profits of other firms and pretended that the increase reflected their efficiency. Partly, they paid cash, but preferably they used their own highly valued shares as currency. Prevailing rules required that they pay a price heavily above market value and even more vastly in excess of book value. The difference went as capitalized goodwill into the balance sheet of the acquiring firm. Maintaining the illusion of rapidly rising profits required new acquisitions in rapid sequence. Meanwhile the long-term costs of this short-term policy have been ballooning: indebtedness, interest expenses and valueless goodwill. What we presently observe in the collapse of reported profits is the bankruptcy of the shareholder value strategies, and there is far worse to come.***

## DOLLAR MYSTERY

There is one thing in this development that has taken us by surprise, and that is the dollar's resilience. It inherently implies that foreign investors and lenders are recycling the dollar deluge pouring out of the United States from current-account deficit and capital outflows, amounting together to more than $500 billion per year.

In the first place, the dollar's resilience is just another confirmation that the general, longer-term optimism about the U.S. economy and its coming V-shaped recovery remains unshaken. Strikingly, currency markets continue to react in a distinct asymmetric manner to economic news from the United States and Europe. Downbeat U.S. data are virtually ignored in the apparent assumption than an economic revival is around the corner. Poor data from the euro-zone, by contrast, always draw tremendous publicity and attention and generally send the euro lower.

There is manifestly a deep-seated positive market sentiment towards the U.S. economy and its currency on the one hand, and just as manifestly a deep-seated negative market sentiment towards Europe's economy and its new currency on the other. Both are grossly misplaced.

Few doubt that the U.S. economy is already in recession, and in any case it is slowing much faster than the European economy, yet most reports give the impression that the situation is just the reverse. But however strong the prejudices, reality will take over in the market in due time. Ironically, for us though typically, European firms are making their biggest losses in America.

But what are the main sources of these continuous U.S. capital inflows? It's both the most puzzling and the most important question, considering that it needs unhedged flows for a strong dollar. The Bank for International Settlements identified in its recent *Quarterly Review* one source as *"ultimately responsible for most of the rise in claims on U.S. non-bank corporations: Foreign banks' indirect purchases of U.S. securities via their local subsidiaries in the United States."* We would say the basic fact here is that the U.S. corporate credit explosion has been spilling over to international banks abroad where credit demand is much weaker.

## CONCLUSIONS

The U.S. economy is crumbling fast. The immediate key causes are plunging profits and capital spending. But the root cause has been conclusively identified: grossly inflated consumer spending, as reflected in the collapse of personal saving and the explosion of the trade deficit.

What we saw in the past few years was not a new paradigm U.S. economy bursting of health but a bubble economy that has been bursting of unprecedented credit and debt excesses. Ever-looser money and credit and overconfidence are maintaining the illusion of stability of an economy and a financial system that are in reality vulnerable as never before. Not only stocks, but also bonds are in grave danger of a severe decline, once the dollar cracks.

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